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**THE BLUM FIRM, P.C.**

# **BUSINESS SUCCESSION: A PLANNING ROADMAP**

## **Bank of Texas Seminar Series**

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# THE BLUM FIRM, P.C.

- Largest estate planning firm in Texas
- Offices in Fort Worth, Dallas, Houston, and Austin
- 20 Attorneys
  - 8 are also CPAs
  - 9 Board Certified in Estate Planning
  - 2 Board Certified in Tax
- Boutique firm practice devoted to estate planning and related areas of tax, probate, asset protection, closely-held business planning, and tax-exempt organizations

# BUSINESS SUCCESSION: A PLANNING ROADMAP

**When it comes to planning for the sale of a business, the end goal is simple:**

**MAXIMIZE SALES PRICE and MINIMIZE TAXES.**

While achieving this goal can be a complex process, it is important to remember that *timing is everything.*

- **Rule of thumb: The more time you allow for planning prior to a sale, the greater the potential payoff.**
- Generally, the pre-planning should occur in three main stages:
  - Stage 1: Deciding to sell
  - Stage 2: Preparing the business for sale
  - Stage 3: Engaging in tax planning

# STAGE ONE - DECIDING TO SELL

**Before there is a sale, there must be a decision to sell.**

- Choosing to sell is often a very difficult process, especially within the context of closely-held businesses.
- Many business founders are reluctant to entertain the idea of transferring ownership of their business.
- Although selling a business is often the wisest choice for a founder, in some instances it may be possible to successfully transfer a business to the next generation.
- (See handout, “Estate Planner’s Role in Business Succession Planning: A Ten Step Guide,” for an in-depth discussion of the various factors involved in business succession planning.)

# Why is a sale DURING LIFE often the best choice?

- A company may devalue at the founder's death.
- Selling can often avoid family dysfunction.
- If the founder's heirs aren't already in management positions, they won't be in the best position to sell the company upon the founder's death.
- A founder's death is traumatic; not the best time for business negotiations.
- Heirs rarely speak with one voice—conflict is common.

- When a founder dies, anxiety and uncertainty among the heirs related to the business may cause a quicker sale than makes economic sense.
- A sale during life allows the founder to be involved in the process, which makes for a smoother transition.
- *Bottom line: a sale can often maximize value and preserve family harmony.*

# STAGE TWO – PREPARING THE BUSINESS FOR A SALE

- **Goal: Maximize the value of the business.**
- There are consultants who specialize in identifying the inefficiencies of a business and in providing recommendations to ensure the best sales price.

- **Important factors for maximizing value from a BUYER's standpoint:**
  - Are the business financials in order?
  - Where is the market going? When is the best time to sell?
  - What are the intangible values of the company (key employees, internal processes, reputation of quality)?

- **Important factors for maximizing value from a TAX standpoint:**
  - Is the current entity structure the best for tax purposes?
  - Planning to eliminate the 3.8% NII tax?
  - Planning to reduce the double tax hit if selling C Corp. assets?
  - Planning to optimize charitable deductions?
  - Planning to reduce estate tax?

# STAGE THREE – TAX PLANNING

- While preparing the business for sale is about maximizing the sales price, tax planning is about maximizing the amount of sale proceeds *you actually get to keep.*

- Note: Even if you do not plan to sell the business to an outside party *or at all*, estate tax planning is a smart move for two main reasons:
  - 1) “Squeezes” down the value by locking in discounts (for lack of control and lack of marketability) that may not be available in the future.
  - 2) “Freezes” the value of the estate by moving future appreciation outside of your estate.
- This is known as “Squeeze & Freeze” planning.

## Why is estate freeze planning important?

- When you die, if your assets are above the federal estate tax exemption level (\$5,340,000 if single; \$10,680,000 if married), the federal government will take 40% of those assets.
- Many people currently under the exemption level are growing their estates, and their net worth will well exceed the exemption level by the time they die.
- Their family will have to find the liquidity to pay the estate tax.
- The earlier you start, the more tax you can save.

## Estate planning also provides asset protection.

- If you are sued and have a judgment against you, the creditor can take assets you own in your own name.
- Transferring assets out of your own name prevents creditors from having access.
- **By and large, except for retirement assets, you should never own any assets in your own name.**
- Assets should be put into **entities** like limited partnerships, and the entities should be owned by **trusts**.

## **An example of the consequences of doing no planning:**

- Bob and Lisa together had a very large estate. Although they had a high net worth on paper (company valued at \$75 million and \$10 million in other assets), their estate was very illiquid.
- When they both died unexpectedly in an accident, the IRS sent their children a tax bill for \$30 million (\$85 million less \$10 million in exemptions, x 40%).
- A Section 6166 long-term payout was not a satisfactory solution for the family.
- The children had to resort to a fire sale of the company to pay the tax.

**Many people are reluctant to engage in estate freeze planning because of the *fear that they will lose access to and control of an asset* after it is removed from their estate. This is especially true when the asset is a family business.**

***But...***

***There is a way to have your cake and eat it too!***

Through 678 Trust planning, business owners can move the business outside of the estate (thereby “freezing” the asset’s value for estate tax purposes), *without giving up control and without giving up access to the asset.*

Let’s **rewind the clock** on Bob and Lisa and show what would have happened with proper planning. . .

## **“Tax Fence” Without Planning**

**Assets Inside Estate and Subject to  
40% Estate Tax and Creditor Claims**

**PERSONAL  
ASSETS**  
(household items,  
bank accts, etc.)

**FAMILY  
COMPANY**

**PERSONAL  
RESIDENCE**  
(protected from  
creditors)

**RETIREMENT  
ASSETS**  
(protected from  
creditors)

**Assets Outside Estate and Protected from  
40% Estate Tax and Creditor Claims**

## “Tax Fence” With Planning

**Assets Inside Estate and Subject to  
40% Estate Tax and Creditor Claims**

**PERSONAL  
ASSETS**  
(household items,  
bank accts, etc.)

**NOTE  
RECEIVABLE**  
(from sale to 678  
Trust)

**PERSONAL  
RESIDENCE**  
(protected from  
creditors)

**RETIREMENT  
ASSETS**  
(protected from  
creditors)

**Assets Outside Estate and Protected from  
40% Estate Tax and Creditor Claims**

**678 TRUST**

**CHILDREN’S  
TRUST**

5/6

1/6

**FAMILY  
COMPANY**

\*Assets on this side of the tax fence are used to pay income tax generated by assets held on the other side of the tax fence.

## First Layer of Tax Planning: Examine the Entity Structure

- Create a structure that qualifies for the best possible valuation discount.
  - If an LLC or Limited Partnership, examine the agreement to ensure that the entity will qualify for an optimum valuation discount.
  - If a C Corp., transfer stock to a limited partnership.
  - If an S Corp., reorganize the structure to establish voting and non-voting shares. Perform tax planning with the non-voting shares, which qualify for a valuation discount.

## Second Layer of Tax Planning: A Grantor Trust for the Children

- Bob and Lisa create an Intentionally Defective Grantor Trust (“IDGT”) for their children.
- Assets held in an IDGT are outside of Bob’s and Lisa’s estates for estate tax purposes.
- The IDGT can be structured so that the assets also avoid estate tax at the deaths of Bob’s and Lisa’s children and grandchildren.

## Grantor Trust for Children (cont'd)

- Gifts made to an IDGT are “supercharged” because the grantors (Bob and Lisa) remain liable for the income tax attributable to the trust and pay the trust’s income taxes, which helps to reduce their taxable estate.
- The payment of income taxes is not treated as a gift to the trust.
- The grantor status can be “toggled off” later if the Bob and Lisa no longer wish to bear the trust’s income tax.

## Grantor Trust for Children (cont'd)

- Bob and Lisa make a “seed gift” of 1/6<sup>th</sup> of the company to the trust, using a portion of each spouse’s \$5,340,000 lifetime gift tax exemption and generation-skipping transfer tax exemption.
- As beneficiaries, Bob’s and Lisa’s children and their descendants would be entitled to distributions as necessary for their health, education, maintenance, and support.
- The assets in the Children’s Trust would be protected from the children’s creditors and divorcing spouses.

## Grantor Trust for Children (cont'd)

- Bob's and Lisa's seed gift, assuming the company is worth \$75,000,000 and qualifies for a 35% valuation discount, has a value of \$8,125,000, resulting in a gift of \$4,062,500 from each of Bob and Lisa.
- As a result of the gifting, the 1/6<sup>th</sup> interest and any further appreciation on it are removed from Bob's and Lisa's estates.

## Third Layer of Tax Planning: 678 Trust “Estate Freeze”

- Bob and Lisa still own 5/6<sup>th</sup> of the company. To transfer the 5/6<sup>th</sup> outside their estates, they **SELL** it to a new “678 Trust” in exchange for promissory notes.
- A 678 Trust is a unique vehicle that combines asset protection, estate tax savings associated with the “estate freeze” techniques, *and the continued ability to benefit* from the assets built up over the years.
- A 678 Trust is established by a third party (a parent, sibling, or close friend) with a gift of \$5,000.
- Note: Bob and Lisa **SELL** assets to the 678 Trust; they **NEVER** make a gift to it.

## 678 Trust “Estate Freeze” (cont’d)

- Because the 678 Trust is created by a third-party trustor, Bob and Lisa can be beneficiaries of the trust.
- Because Bob and Lisa are the primary beneficiaries, they can receive distributions for health, education, maintenance, and support.
- For income tax purposes, Bob and Lisa will be treated as the “owners” of the 678 Trust, which means there is no income tax when Bob and Lisa sell the business to the 678 Trust. Also, Bob and Lisa will be responsible for paying the income tax on the income generated by the trust’s assets during their lifetimes.

## 678 Trust “Estate Freeze” (cont’d)

- Assets inside the taxable estate can be used to pay the income taxes, allowing the trust assets to grow without being depleted by income taxes.
- If Bob and Lisa were unable to pay the income taxes out of their own assets, the 678 Trust could make payments on the notes owing to them.
- After the notes have been paid, the 678 Trust could make a distribution to them in the amount of the income taxes due.

## 678 Trust “Estate Freeze” (cont’d)

### RECAP

- Bob and Lisa sold their remaining 5/6<sup>th</sup> of the company to the 678 Trust for \$40,625,000 ( $\$75,000,000$  less 35% discount  $\times$  5/6 = \$40,625,000).
- Bob and Lisa each received a 9-year promissory note for \$20.3 million in return, plus interest at the mid-term applicable federal interest rate (currently, approximately 2%).
- The Children’s Trust pledges its assets to guarantee a portion of the promissory notes.

## 678 Trust “Estate Freeze” (cont’d)

### RECAP

- The sale to the 678 Trust immediately moved \$21,875,000 out of their estates (the value of the discount) providing instant estate tax savings of \$8,750,000.
- In addition, there was a \$4,375,000 discount on the gift of 1/6<sup>th</sup> of the company to the Children’s Trust, saving an additional \$1,750,000 of estate tax.
- **Total savings of \$10,500,000 from valuation discounts alone.**

## 678 Trust “Estate Freeze” (cont’d)

### RESULTS

- The Children’s Trust:
  - Owns 1/6<sup>th</sup> of the company and will benefit from the future appreciation of the company.
  - The assets within the trust are protected from creditors.
  - The trust itself does not have to pay income tax as long as the grantor status of the trust is maintained.
  - Will be protected from estate tax at the deaths of Bob and Lisa, their children, and possibly their grandchildren.

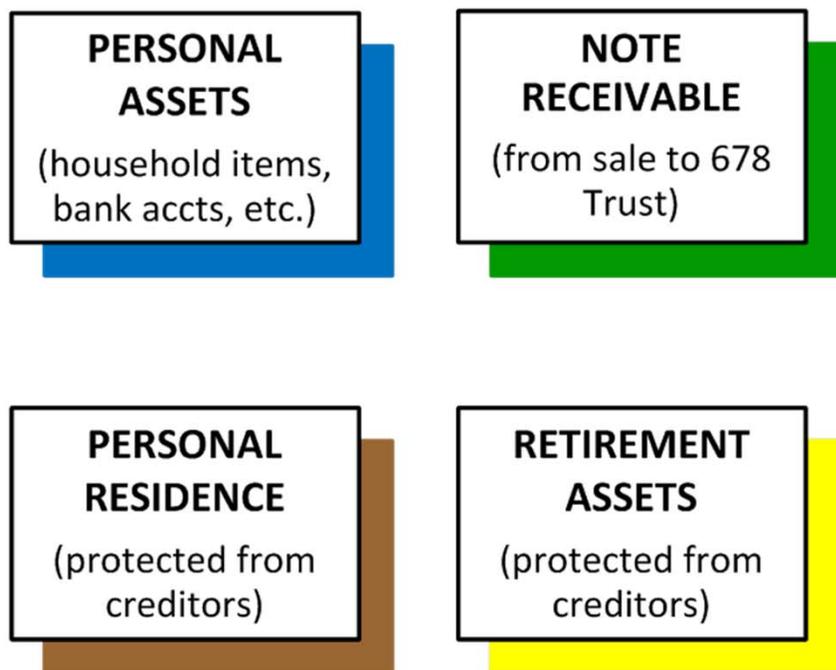
## 678 Trust “Estate Freeze” (cont’d)

### RESULTS

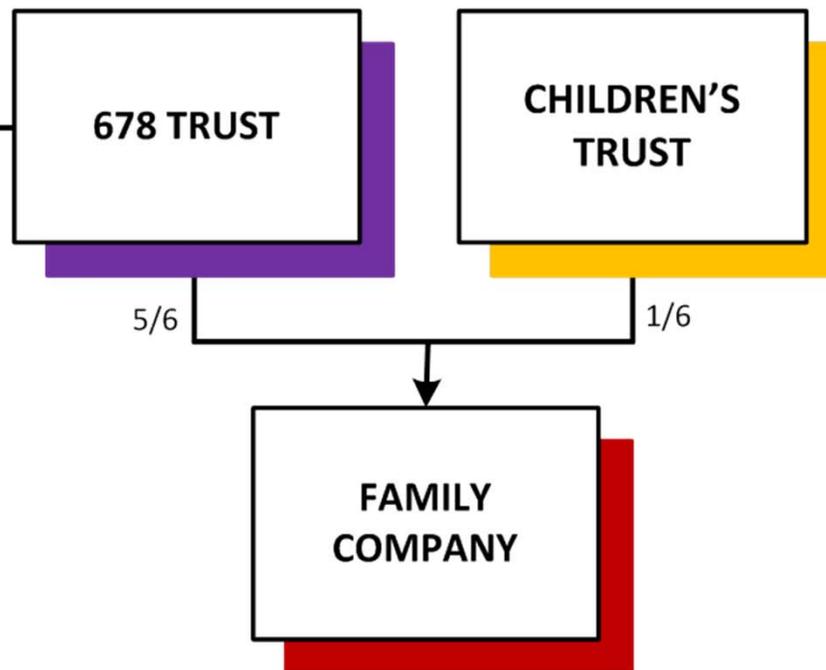
- The 678 Trust:
  - Owns 5/6<sup>th</sup> of the company assets and will benefit from the future appreciation of the company.
  - The trust will make principal and interest payments on the promissory notes payable to Bob and Lisa.
  - The assets in the trust are protected from creditors.
  - Will be protected from estate tax at the deaths of Bob and Lisa, their children, and possibly their grandchildren.

## “Tax Fence” With Planning

Assets Inside Estate and Subject to  
40% Estate Tax and Creditor Claims



Assets Outside Estate and Protected from  
40% Estate Tax and Creditor Claims



\*Assets on this side of the tax fence are used to pay income tax generated by assets held on the other side of the tax fence.

## 678 Trust “Estate Freeze” (cont’d)

### RESULTS

- Assuming Bob and Lisa live until the promissory notes are paid in full and assuming assets in their estates have been spent down to cover living expenses and income taxes, **their estate tax can be reduced to zero.**
- Had Bob and Lisa not engaged in active estate planning, approximately **\$30 million in estate tax would have been due.**
- Additionally, there would have been a 40% estate tax on any appreciation if the company’s value continued to grow.

## 678 Trust “Estate Freeze” (cont’d)

### RESULTS

- Upon a sale of the company:
  - $1/6^{\text{th}}$  of the sales proceeds pass to the Children’s Trust.
  - $5/6^{\text{th}}$  of the sales proceeds pass to the 678 Trust.
  - ALL of the sales proceeds are outside of Bob’s and Lisa’s estates.

**QUESTIONS?**